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Abstract
We investigate whether estimated effective tax rate (ETR) in the first, second, and third quarters are systematically higher than year-end ETRs, consistent with managers building slack into their estimates. We hypothesize that changes from 1rd to 4th quarter effective tax rates (ETRs) are negatively related to whether and how much a firm's earnings absent tax expense management miss analysts' consensus forecast, a proxy for target earnings.
We provide robust evidence that firms lower their projected ETRs when they miss the consensus forecast, consistent with firms decreasing their tax expense if non-tax sources ofearnings management are insufficient to achieve targets. Our findings that patterns of annual ETR estimates and revisions are consistent with incentives for building slack that can later be used to manage earnings contribute to research about how earnings management is accomplished.
We provide robust evidence that firms lower their projected ETRs when they miss the consensus forecast, consistent with firms decreasing their tax expense if non-tax sources of earnings management are insufficient to achieve targets. We also find that firms that exceed earnings targets increase their ETR, but this effect is smaller. By studying the tax expense in total, rather than narrow components of deferred tax expense, our results provide general evidence that reported taxes are used to manage earnings.
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